DOW THEORY LETTERS INC.

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THE PICTURE: This is the last Letter of 1971, and before I forget I want to start by wishing my brilliant, loyal, marvelous subscribers the best for the New Year. It may be a rough year ahead, but it is well to remember that "man does not live by bread alone". If they did, all millionaires would be happy, and corporation heads would never commit suicide. And the faces on the poverty-stricken Mexicans which I just saw (Mexico is 20 miles south of here) would all be lined with tears—which is not the case. Actually, I see more happy faces in Mexico than I do in the States.

So, I want to be so bold as to say that gains or losses should not be the measure of our happiness or sorrow. Two thousand years ago the prophet from Galilee said "What can a man give to buy back his life?" Can all the 73,000 tons of gold that have been mined since the dawn of creation purchase a single life? Can the wealth of King Midas change a childhood that has been wrecked by tragedy?

This being the last 1971 Letter (yes, I'm getting back to the stock market), I felt it might be the time to include a few historical charts. The first is my semi-logarithmic chart of the three D-J Averages (weekly) going back to 1966, when the primary bear market began. Another is the chart of the Dow Industrials and the advance-decline ratio going back to 1919. A third is the chart of the D-J 40-Bond Average going back to 1915. The last two charts cover equities and debt vehicles over the past half-century, and the first covers the three major Averages over the past five years. To fully understand the meaning of the price movements on these three charts would be beyond the ken of anyone I know or have ever met on Wall Street — or anywhere else. But undaunted, I will do my best to tackle them.

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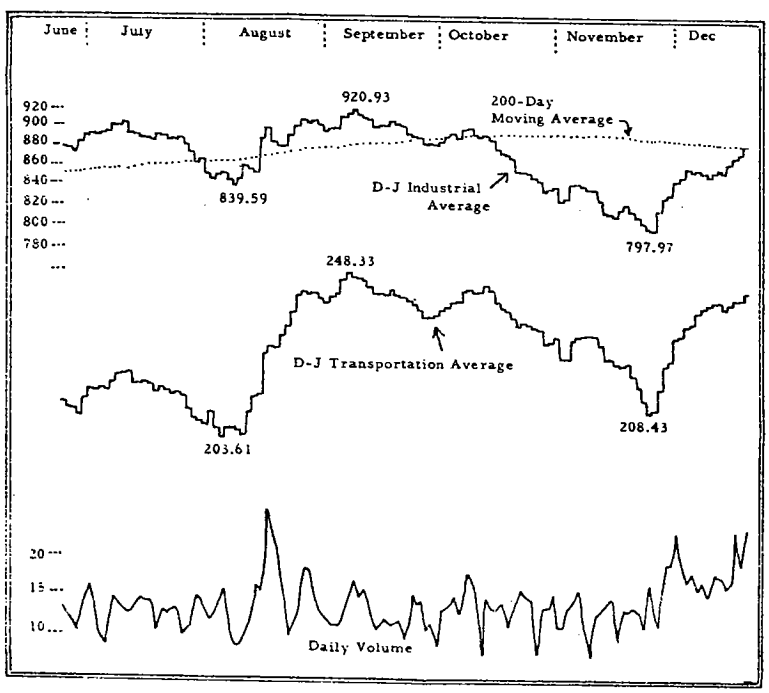
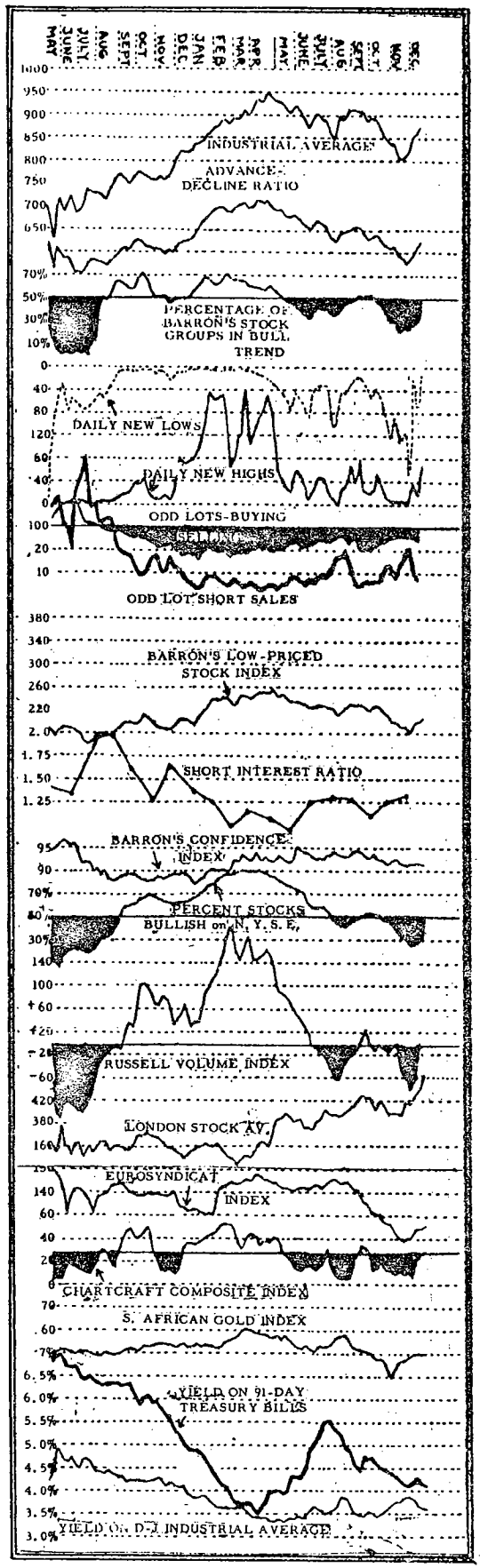
What has occurred with the new token dollar devaluation and realignment of currencies is more a publicity stunt than a permanent solution to world monetary





 and trade problems. The new agreements are calculated by the Nixon Administration to buy time, and I would say that they may possibly buy enough time to get the Administration past the 1972 elections (but don't count on it with a primary bear market on).

`e agreements will help U.S. trade to some extent, but I don't think they will begin to stem the import flood, and I doubt if ey will produce a U.S. trade surplus. But the new agreements will hurt European and Japanese exports, and Japanese Foreign Minister Fukada termed them "the greatest economic shock" for Japan since World War II.

My friend, Dr. Harry Schultz, sizes up the situation as follows: "Wallpaper can't hide the true situation for long. All that is being currently achieved is an armed truce, a cease-fire, not an armistice. Due to its behavior since Aug. 15, the U.S. has alienated itself both from Europe and Japan to a degree not even faintly imagined by the people who live in the U.S. It will not regain Western leadership in this decade, and perhaps never".

Little is being said about the fact that dollar convertibility has not been achieved, little is being said about the massive $65 billion which central banks around the world are now stuck with. What does non-convertibility mean? Again, I will turn to Dr. Schultz. "The world will have to face up to the fact that it is giving America goods, services, factories, companies, patents, vacations — all real values — in return for paper, paper which cannot be cashed in. The world monetary leaders know this today. But they dare not confess it to the public lest a panic ensue. They must try to keep the lid on, continue to accept phoney money in exchange for real value as long as possible, hoping that somebody will come up with a solution". (Thanks Harry, no one could have said it better).

The brutal fact, the fact that no one wants to face, is that the dollars which the U.S. passes out are worth much less than the new value, the one-thirty-eighth on an ounce of gold which resulted from the December, 1971, devaluation. A true devaluation, bringing the dollar to a rate of perhaps $100 or more per ounce of gold, with full currency alignments, would have meant that there was a chance of making the dollar fully convertible. But no such fundamental path was followed.

Thus, the problem was glossed over in a trade for time, and within months I expect the same old problems to emerge. The U.S. will not be competitive, currencies will not be convertible, but one new ingredient will be added. Despite the removal of the 10% U.S. surcharge, I believe the rest of the Free World will move further into a slump, with the new currency alignments making it somewhat more difficult for foreign nations to export goods.

In the meantime, an interesting monetary feature may be expected. Foreign central banks have been buying dollars at the incredible rate of $1.3 billion per week to support the dollar against their own rising currency values. This buying has totaled $25 billion for the year in U.S. Treasuries, and these purchases have served to keep U.S. interest rates low. They have also served to finance huge U.S. deficits. The process should shortly be reversed however, as foreign central banks (chiefly Japan and Germany) sell those Treasuries, thereby driving interest rates back up again. The Fed will then have to go into the U.S. domestic market to do its financing, and that should be interesting, considering the whopping deficit coming up (thanks to Eliot Janeway and Dr. John Shea for the above).

The stock market celebrated the monetary "solutions" with an 11 point Dow rise on 23 million shares (December 20). This brings the Industrial Average within points of its 200-day moving average (page 1 chart), and since most strong corrections in bear markets take the Industrials to or perhaps somewhat above their 200-day moving average, this was not unexpected. Again the loud voice of "the Dow over 1000" is heard throughout the land, and all I can say is that I doubt it.

It has been almost six years since the Industrial Average has recorded a new high. This has not occurred since the 1930's, and is a phenomenon which only occurs during a primary bear market. It is characteristic at the bottom of a bear market for the pessimism and gloom to be rampant. Nothing can cut through it. Yet, note that at the November low "everybody" was bearish, and here a little more than a month later, Wall Street is talking about "1000 on the Dow" next year. Hardly the kind of psychology I would expect at the end of a six-year bear market. No, I'm sorry to say it, but the bear is far from having completed his work. And I guess I will end this section with a quote from Bob Dylan's Times Are A'Changin'.."The line it is drawn, the curse it is cast, the first one now will later be last..."

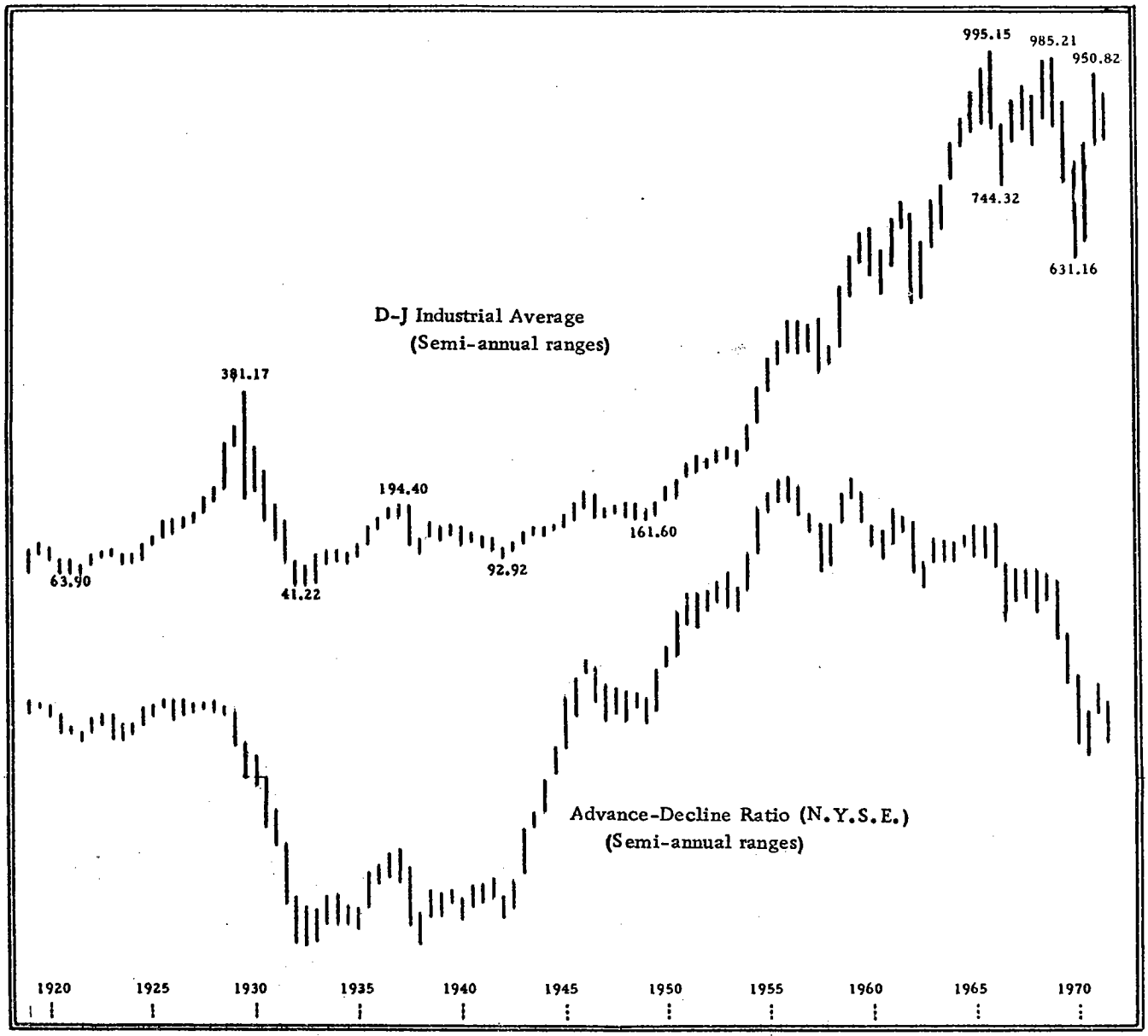
1966-71 The chart on page 3 is a weekly (high-low) chart of the three D-J Averages, plotted to semi-logarithmic or ratio scale. The ratio scale means that all movements are comparable in percentages, and that a rise of 10% in the Utility Average will show up as the exact same vertical distance as a 10% rise in the Industrial or Transport Averages. Since we make or lose money `` the stock market on the basis of percentages, the value of this chart can easily be understood.

Let me take the percentage feature one step further. If you own $5,000 of IBM at $300, and the stock rises 10 points, that's a very small percentage gain (3.3%) since it's a high priced stock. In other words, you won't make a killing on a 10 point rise in IBM. But if you own $5,000 of a $5 stock and the stock gains 10 points, that's a fat 200% gain. Thus, it's the percentages that count in the stock market, and a ratio scale chart shows those percentages.

It is immediately apparent that the big percentage moves up or down have been in the highly-leveraged Transport Average. Unexpectedly, the decline from the 1966 peaks to the 1970 lows in the Industrial and Utility Averages were almost the same in percentages. Thus, the Utilities (which are considered the ultra investment-grade issues) kept up with Industrials on the 1966-70 decline. I consider this a bearish omen, since this suggests that the highest-grade Average (Utilities) was sold off as much as were the Industrials, a sign of informed or "high-quality" selling.

However, (use your dividers or a ruler if you wish) on the advance from the 1970 lows, the Utilities failed by a wide percentage margin to keep up with Industrials. Obviously, the investment-grade Utility Average was not receiving anything like the buying in the Industrials or the speculative Transports. This again I take as a negative sign, a sign that informed money was being very reticent on the advance from the 1970 lows.

Finally, on the rally from the November, 1971, lows, the Utilities failed by a very wide margin to keep up with the gains in Industrials and Transports. Again, the same line of reasoning may be used. It is worth repeating here that the Utilities have tended to be a bellwether or leading indicator for the market. Since 1966, Utilities have been the weakest of the three Averages and today finds them further (in percentages) from their 1966 peak than either the Industrial or the Transport Averages.



ADVANCE-DECLINE RATIO: On the wall of my office I have a chart (which I laboriously drew) showing the monthly A-D ratio and Dow Industrial ranges going back to the year 1919. It is a fascinating chart (measuring three feet across) and one that I could not possibly put in this report. However, I have condensed the chart so that semi-annual ranges are shown (two vertical bars for each year), and I have included that chart in this Letter. I believe this semi-annual chart shows many things which are of great interest at this time.

First, I feel it is interesting to note that the A-D ratio tends to form huge sideways bases and tops, then make massive movements (up or down) from those bases or tops. Today one often hears that the A-D ratio has a downward bias. History simply does not support this view. For instance, note the amazing A-D base which stretches from 1932 to 1942. This covers the years from the Great Depression to the depths of World War II. Actually, the tide of war began to turn in favor of the Allies in 1942, at a time when it seemed (during most of early 1942) as if the Axis might well conquer the Free World.

The rise in the A-D ratio from 1942 to 1946 was incredible. Almost everything on the N.Y.S.E. climbed up for four straight years. Then there was a sideways movement in the A-D ratio from late 1946 to the recession low of 1949. In late-1949 the A-D ratio again headed up, and everything that wasn't "glued down" moved higher until 1956. The year 1956 proved to be the peak of the A-D ratio and the ratio moved sideways until 1966.

From 1966 to 1970 the A-D ratio literally fell apart. Every stock that could move (with few exceptions) declined. The widespread force of the primary bear market which began in 1966 is far more apparent on the A-D ratio than it is in the profile of the Dow Industrials. Actually, this probably (more than anything else) explains the mass exit of the public from Wall Street

over the past five years. The fact is that the public (as seen by the A-D ratio) lost its shirt in stocks after 1966.

We have been getting a small sideways movement on the A-D ratio since 1970, even while the Dow has been tracing out its series of descending tops and bottoms. My guess is that when the bear market goes into "high gear" as the second phase ends and as the third phase of the bear market winds out its way, the A-D ratio will make another great downward leg comparable to 1966-69.

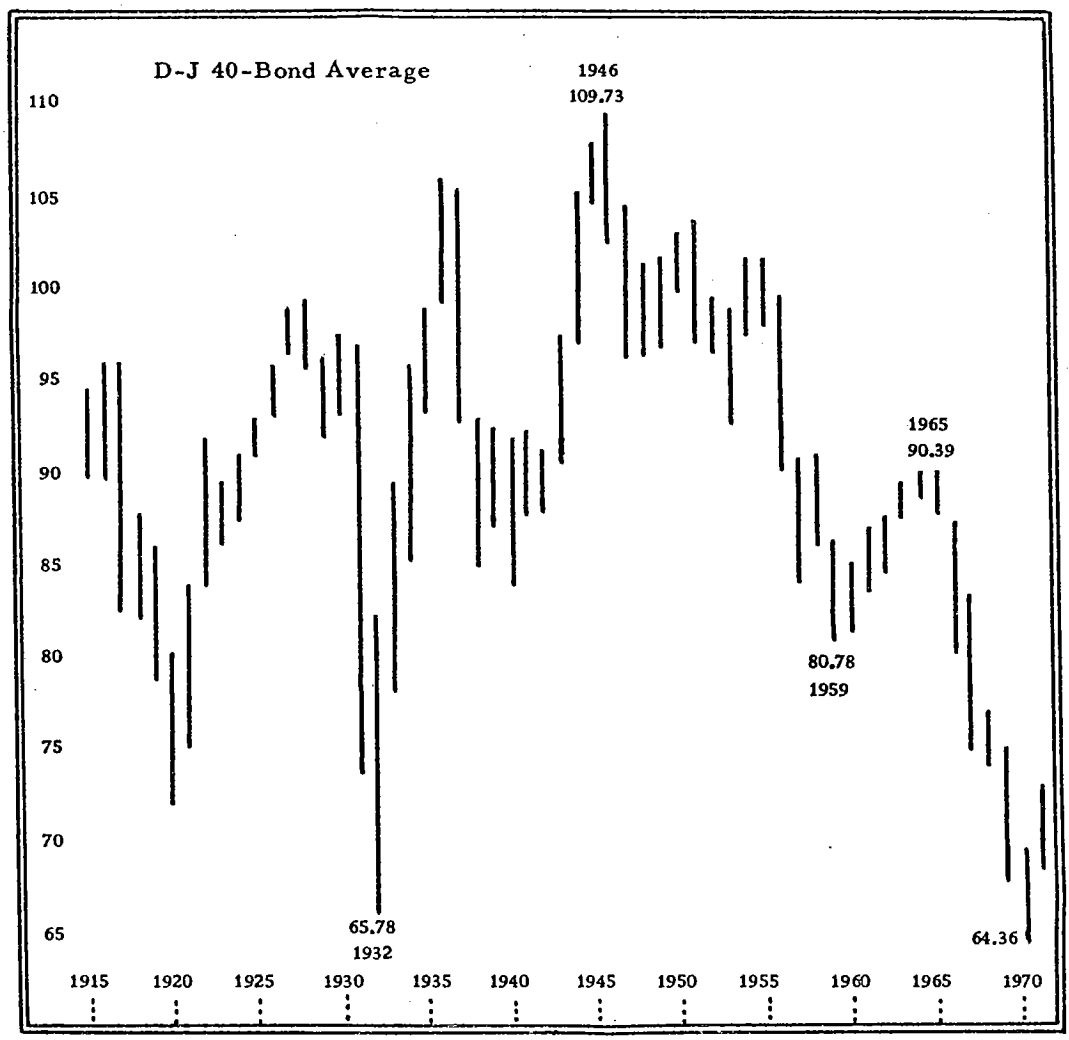
That will mean that almost everything on the Board will plunge to lower levels, and from there (as the third phase of the bear market ends) I feel we will consolidate as informed investors begin accumulating stocks for the next great bull market.

I believe the next primary bull market will show the kind of upside move in the A-D ratio which characterized 1942-46 or 1949-56. That means that everything that can move will be going higher, and fortunes will be made in diversified and growth portfolios. That's what I think this chart is telling us. Let history be the judge.

BONDS: Here is a yearly (annual high-low) chart of the broadly-based D-J 40-Bond Average going back to the year 1915 (statistics from pen pal C. Coleman Petty of Louisville, Ky.). The chart shows three major bull markets in bonds and four major bear markets. It should be apparent that bull and bear markets in bonds generally are greater and last longer than bull and bear markets in stocks.

For intensity and violence, the bear market years of 1931 and 1932 have never been equalled as far as bonds are concerned. During those two years the 40-Bond Average broke from 97 to a 1932 low of 65. Thus, one-third of total bond values were wiped out in a period of two years.

A great and explosive bull market in bonds followed, taking the index to a high of 106 in 1936. From there a bear market took the Bond Average to its 1940 pre-World War II low of 83. With the Government "pegging" the price of bonds to finance the War, a new bull market in bonds carried the index to its record 1946 peak of 109.73.



From that historic 1946 high, bonds entered what must be termed the longest and worst bear market in their history. By 1970, the 40-Bond Average had touched a low of 64.36 (actually below the Great Depression low!) after having lost 41% of its peak value.

What has caused this collapse in the bond market? I would say that the collapse has stemmed basically from the new philosophy which has by now permeated every sector of American society. The philosophy can best be described as "enjoy now and pay later". Thus, the spiral of debt in all segments of the society keeps climbing, the interest on the debt continues to climb, and the periodic rallies in the bond market get weaker while the declines become more and more vicious.

In order to finance today's "happiness", the Government has had to resort to every conceivable trick in the inflationer's arsenal. Printing press money has been used, the silver has been taken out of our coinage, U.S. citizens are prohibited to own gold, the gold backing of the U.S. dollar has been steadily decreased, and as of August 15 even foreign creditors were denied the guaranteed right of exchanging dollars for gold. On August 15 the U.S., down to $10 billion in gold bullion (much less if even our gold-guaranteed bonds were deducted), embargoed gold and proclaimed to the world that we could not honor our debts with the medium by which the dollar's value is defined — gold. Four months later, the first dollar devaluation (there will be more) since 1934 occurred.

The August embargo left foreign creditors sitting with upwards of $60 billion in claims, all of which legally could have been presented for gold. The monetary system was wrecked, the dollar became a floating piece of green paper, and the bond market (relieved that at least the bad news was out) entered upon a rally.

The rally can be seen in perspective on the chart. Personally, I believe it is an abortive rally, another rally in a continuing bear market in bonds. I know of no bear market in bonds which has ended without a liquidation of debt, and so far there has been nothing but debt building in the U.S. I expect, within a year or so, the debt liquidation will descend on the U.S., and when this happens I expect to see the final plunge in the bond market. From those liquidation lows, the next major bull market in bonds will begin.

GOLD & SILVER: Referring to our weekly chart, gold bullion sold off slightly (as shown) following the token U.S. devaluation, but on December 21 gold jumped back over $43 per ounce. Does the U.S. really expect gold to sink to the $38 devaluation price? If so, then why does the free market price stay above $42 as shown on the chart? Will other nations buy and sell gold at the official U.S. price of $38 per ounce? I doubt it, and certainly the producing gold mines will be selling at the free market price which is $4 above the price at which "the U.S. would sell gold if it had it to sell." And so the joke goes on — until something unravels.

I still feel that silver bullion is basing. It would be normal to have a few more "scary" dips, but I doubt if silver is going to break the $1.30 mark again. Meanwhile, silver mining shares are very depressed and could well be under accumulation too (see last Letter).

The Amro-Pierson stock Average has rallied some, probably due to the removal of a few doubts (at least temporarily) on the international trade front. This will be an important indicator to watch during the coming year; it will reflect international corporate health, or the lack of it.

NOTE: I am going to take a few days rest. The next Letter will therefore be mailed on January 7, 1972. Until then, my very best to you all....

ANOTHER NOTE: I just received a new magazine entitled "Capitalist Reporter". It is a "how-to" poop-sheet for the amateur who wants to make "more money". The magazine is written in a very jazzy, frenzied style, indicative of the mentality of the reader it is aimed at. I believe the magazine is written for the vast portion of the U.S. population which can't make ends meet, the segment which is being harried and worried to death by mounting inflation, debt and rising bills. The year 1972 will find three-quarters of the U.S. trying to "Beat the Devil". The devil is greed, and that engine of inflation which is a product of political greed.